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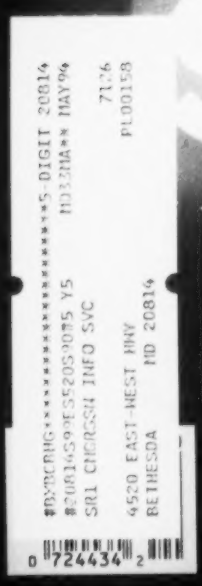
FORTUNE

WHY JAPAN STRONGER



MAY 18, 1992

VOL. 125, NO. 10

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"The trump card Japan will play in the second half of the 1990s will be its strategic control of the fastest-growing consumer market in the world." 60

COMPETITION/COVER STORIES

ABOVE: A company song and creed recitation in Japan. Photo by Eiji Miyazawa (Black Star).

COVER: Despite the current economic slowdown, Japan's star is on the rise. Photo by Ron Watts (Westlight).

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EDITOR'S DESK

THE SUN ALSO RISES

■ We try to make a point of getting beneath the obvious. While much of the press is talking about how Japan's current economic troubles will undermine its long-term competitiveness, FORTUNE's two-part cover package pronounces that Japan will rise mightier than ever. In "Why Japan Will Emerge Stronger" (page 46), senior editor John Curran makes the case for the current slump as, in fact, a shrewd strategic move that will bring Japan into an era of more manageable prosperity. Senior editor Richard Kirkland, in "What if Japan Triumphs?" (page 60), lays out how the U.S. will be affected if Japan becomes the reigning economic power.

Curran (left) and Kirkland worked both hemispheres.

Curran, who is also FORTUNE's investment editor, isn't averse to defying the conventional wisdom on Japan. He won an Overseas Press Award in 1988 for a prescient article on Tokyo's stock market. To report his current story, he went to Japan to tap a network of sources he has built up over the years. He also relied on some of our Tokyo crew—reporters Emily Thornton and Cindy Kano. During his trip, which coincided with cherry blossom season, Curran was surprised to see how optimistic the Japanese remain. Says he: "There is none of the gloom in public sentiment that you see in America."

Emily Thornton

Cindy Kano

Neither is Kirkland a newcomer to Japan or the international scene. In his life before editing our Politics & Policy section, he covered Washington and then served as our chief European correspondent, based in London. Looking back over his 13 years at FORTUNE, he says it all fits together: "If you are going to cover economic policy and politics, Japan has to be part of just about every story."

Kirkland spoke with over 40 experts to parse the implications of Japan's growing strength. "The U.S. has been the undisputed leader for decades," he says. "What worries even the many optimists are all the unknowns a change in power would entail."

Donald Holt, FORTUNE's international editor, who oversaw this cover package, believes our readers will gain a fresh perspective from it: "These stories will stir up response because we are really looking behind, underneath, and ahead of the conventional views on Japan. We are also going against the grain."

Marshall Loeb

MANAGING EDITOR

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PETER YATES—SABA

Striking Kroger workers at a store in Ann Arbor, Michigan

by a coalition of environmental, labor, and consumer groups out to sabotage the Uruguay Round of GATT negotiations. The ads, which cost $74,000, ran in the New York *Times* on April 20 and the Washington *Post* on April 22. That was the day President Bush and U.S. Trade Representative Carla Hills met with European Community President Jacques Delors in what turned out to be another vain effort to persuade Europe to cut agricultural subsidies.

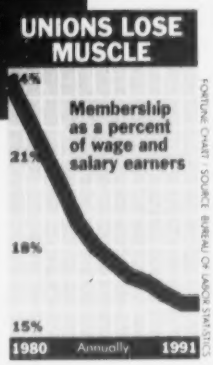
The ads argue that GATT's attempt to harmonize global trade regulations would override U.S. laws that protect health, jobs, and the environment. One example, provided by Lori Wallach, an attorney for Public Interest, the consumer group founded by Ralph Nader: A GATT panel ruled last year that American laws banning the import of tuna not "dolphin-safe" violated international free-trade agreements. The decision suggested that a country could refuse imported tuna only if it was spoiled, say, and a health threat. Says Wallach: "It basically means if the tuna doesn't give you botulism, it doesn't matter if you drown Flipper on the way."

Former Secretary of Labor William Brock, a free-trade supporter, calls the ads "deceptive and irrational." He cites a recent Organization for Economic Cooperation and Development study, which predicts that a new GATT agreement would result in a $195 billion increase in world income by the end of the decade. Says he: "It would be really dumb to regress at this point."

Maybe. But 138 Congressmen are sponsoring a resolution that would vote down any GATT agreement that rides roughshod over U.S. laws.– **R.T.**

CATERPILLAR'S UNION FALLOUT

■ Sometimes unions have the last laugh. Although the United Auto Workers seem to have caved in to **Caterpillar** CEO Don Fites's threat to replace its members with nonunion workers, hiring permanent replacements for strikers at **Ravenswood Aluminum** had a different result. The directors fired CEO R. Emmett Boyle. Among the reasons: Boyle's resistance to renewing negotiations with the United Steelworkers. They went out in November 1990 and were soon replaced.



Union membership is down (see chart), and only two other major strikes are in progress. The International Longshoremen who operate tugboats in New York have been out since 1988. Replacements are at the helm. In Michigan, 7,800 Food and Commercial Union members are striking **Kroger** supermarkets. The longshoremen simply want a better contract than the one offered. But the Kroger strike resembles Caterpillar's—workers want a deal like the one the union reached with **A&P**, a competitor.

These so-called pattern contracts are common industry by industry. But many companies argue that their businesses really have little in common. Caterpillar, for example, says it depends far more on exports than **Deere**, which signed a contract with the UAW.

Detroit has grudgingly accepted pattern bargaining for years. How will this play out when the UAW opens negotiations with the automakers next year? Most industry observers believe that once one company agrees to a contract, the others will argue unique circumstances and try to chip away pieces of the pattern contract. But don't look for threats of replacement workers.

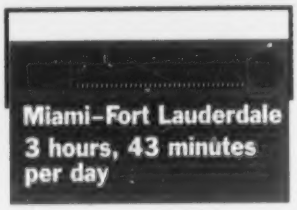
Similarly, the Communications Workers of America are expected to reach agreement with **AT&T** on a contract that expires May 30. These days most employers and workers recognize that jobs are scarce and foreign competition real. Says AT&T Chief Executive Robert Allen: "We have more areas of common interests than differences." **– Andrew Kupfer**

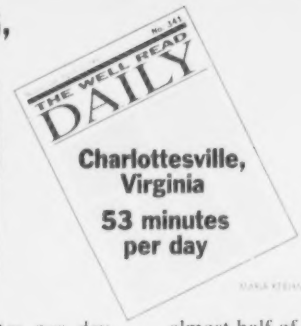
BEWARE THOSE FOREIGN BUBBLES

■ The Tokyo stock market collapse may be the biggest in the past couple of years (for more, see Competition). But the Nikkei's tumble wasn't the only foreign fall. Wild investor speculation in Taiwan, South Korea, and Indonesia—all countries with strong economic growth—inflated share prices until they simply burst.

Amazingly, points out Michael Murphy, editor of the *Overpriced Stock Service* newsletter: "At the time bubbles come apart, no one can quite believe how far down prices will go. But history shows that all bubbles end in busts, and the bigger the bubble," Mur-

TOP CITIES FOR WATCHING, LISTENING, AND READING Per capita





■ Americans watch television, listen to the radio, and read newspapers and magazines as much as they sleep: an average of eight hours, three minutes per day. See above for the cities that devote the most hours to each of these categories. Which city spends the most hours per capita on all forms of media? Youngstown, Ohio. Its denizens put in eight hours and 50 minutes per day, almost half of them in front of the tube.

Young & Rubicam, an ad agency, found that Americans watch TV an average three hours, 48 minutes a day (up 22 minutes from 1975) and listen to the radio for three hours, 21 minutes (up 19 minutes). Newspapers get 34 minutes (a minute less) and magazines 20 minutes (five more). **– R.T.**

phy adds, "the bigger the bust."

Which foreign market could be the next to pop? Some advisers are casting a wary eye on Latin American stocks. Since 1985, many have risen more than 20-fold as governments reformed their economies and privatized industries. Bullish investors—there are plenty—believe these changes will lead to strong long-term growth.

But a skeptical Jean-Marie Eveillard, manager of the top-rated Sogen International mutual fund in New York City, wonders "if it's going to be a repeat of the 1970s, when Americans poured billions of dollars into those markets only to get stiffed." Back then the governments refused to pay back bank debt; this time they could renationalize the companies or, more likely, reverse their policies, causing the stock prices to tumble.

Another "bust" candidate is India, where the stock market has doubled since the beginning of the year, when the government instituted major economic reforms. Says Morgan Stanley investment strategist Barton Biggs: "It's getting toward bubble proportions, with the 20 biggest stocks selling at 50 times earnings. People are buying stocks because of their names rather than their valuations." Example: **Tata Iron & Steel**, which investors have driven up to 80 times earnings since the government decontrolled steel prices. Morgan Stanley's India expert, Vinod Sethi, warns, "Import duties on foreign steel are also coming down and international prices are low. Plus, the company makes poor quality steel." **– Joshua Mendes**

A STEREO BRUTE FROM RUSSIA

■ What do you do when your main customer disintegrates? At least one military supplier to the former Soviet Union has a possible solution. **Okean Tribor**, a St. Petersburg manufacturer of acoustic equipment for tracking submarines, now turns out hi-fi components good enough to catch the attention of Western audiophiles.

One U.S. fan: Keith Johnson, an MIT material sciences professor. He happened across the product last summer while touring Russian factories as a consultant for Batterymarch, a Boston investment firm. Excited by what he heard, Johnson brought home amplifiers, turntables, and speakers so that others could judge—and kept one set for himself. Says the classical music buff: "People who come into my house can't believe their ears."

The professor gave another set to Cambridge Soundworks, a pricey audio catalogue company co-owned by legendary hi-fi innovator Henry Kloss. The outfit liked what it heard and accorded special bravos to the amplifier. Enthuses product manager Walter Schofield: "It's a brute. Its bass is absolutely tremendous."

As a result, Cambridge is investigating ways to import these amplifiers and sell them through its catalogue, perhaps by the end of this year. Okean Tribor has offered to provide them for $100 each. That would leave Cambridge plenty of room to undercut equivalent U.S. and foreign brands that go for $600 to $1,000. **– J.M.**

Professor Johnson with his sundry Russian souvenirs

STEVEN M. LEWIS

NOW HEAR THIS

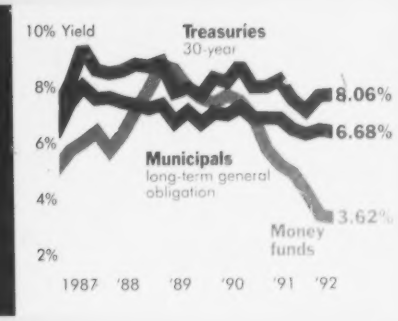
■ **JOHN KENNETH GALBRAITH,** 83, Harvard economist, liberal, and author of 28 books:
"I spent my youth and early manhood worrying about corporate power. Now I worry about corporate incompetence."

■ **MICHAEL A. WEISS,** 51, president of Express, whose chic, fast-growing women's clothing stores are a highly profitable part of the Limited:
"We figured out that a customer base with a salary was better than a customer base with an allowance."

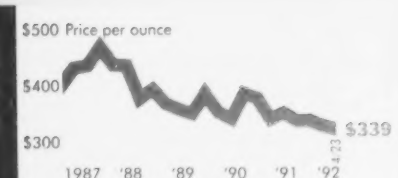
STATE OF THE MARKETS

STOCKS

BONDS



GOLD



FORTUNE CHARTS. CHARTS SHOW END-OF-QUARTER FIGURES.
*BASED ON EARNINGS FOR THE LATEST FOUR QUARTERS.
SOURCES: STANDARD & POOR'S; BOND BUYER; IBC/DONOGHUE'S MONEY FUND REPORT; COMMODITY EXCHANGE

nies **International Paper**, **Stone Container**, and **Georgia-Pacific**. Of these companies he says, "Cost restructuring has generated surprisingly good earnings on very limited sales volume."

Geoffrey Raymond, chief investment officer of Timco, the $4.5 billion money management arm of Travelers, is one of many managers trying to balance growth and value stocks. "Right now the marble is in the middle of the plate, but it is rolling toward the cyclical stocks," he says. One he likes is **Williams Cos.**, a gas pipeline company with a telecommunications subsidiary. The stock sells for ten times Raymond's 1993 earnings estimate. Earnings are growing 25% annually.

And what about that dollop of growth stocks? Plenty are available (see Portfolio Talk). Michael DiCarlo, who runs the John Hancock Special Equities Fund and comanages the firm's global fund, likes a couple of small leisure stocks. **SLM International** makes toys and CCM hockey gear. It sells for $20, and DiCarlo thinks it will earn $1.20 a share this year. He also recommends **Charter Golf**, maker of Ashworth golf shirts. Masters champion Fred Couples is the product spokesman, and the shirts, sold only in pro shops, are jumping off the shelves. The stock goes for $8, or 23 times DiCarlo's per share earnings estimate for this year.

Raymond of Timco has been looking for growth in technology stocks, including software colossus **Microsoft**, which fell recently on a weaker than expected growth forecast and trades near $120 a share. Raymond figures earnings should increase about 28% per year and says, "I think the stock will sell for $150 to $160 in the next 12 months." In the banking sector Raymond favors **Synovus Financial**, which owns banks in Sunbelt states. Its prize possession is Total System Services, a bank card data processor that handles AT&T's Universal Card. That business is booming.

■ **BONDS.** What to do. Yields on CDs and Treasury bills are so miserly that you have to wonder if they're worth the bother, but if you want safety, where else can you look? In a few places, as it turns out, that offer savvy savers decent yields with security.

Start at the Treasury market—but instead of buying a bill, note, or bond, investigate Treasury Strips (a tortured acronym meaning separate trading of registered interest and principal of securities). Essentially zero-coupon bonds, Strips are more volatile than their interest-paying counterparts, but their yields to maturity are higher. For individuals who buy and hold bonds until they expire, that extra yield is a gift.

The cheapest Strips now, says Peter Hegel, who oversees $15 billion in fixed-income funds for Van Kampen Merritt, are those maturing in ten to 17 years. A ten-year Strip currently yields 8% to maturity, vs. 7.60% for a straight bond. In reality the difference may be larger because the straight bond's yield figure assumes that interest can be reinvested in the same bonds, which sell in $1,000 increments. Most individuals won't get interest payments large enough to allow that. Reinvest in a money fund yielding 4%, and the straight bond's yield to maturity falls to 6.61%.

For a three-way tax break—federal, state, and local—head for municipal bonds. Insured bonds, a smart way to bypass state and local budget difficulties, pay less than uninsured issues, but competition

MIXED REVIEWS FOR THE CHIEFS

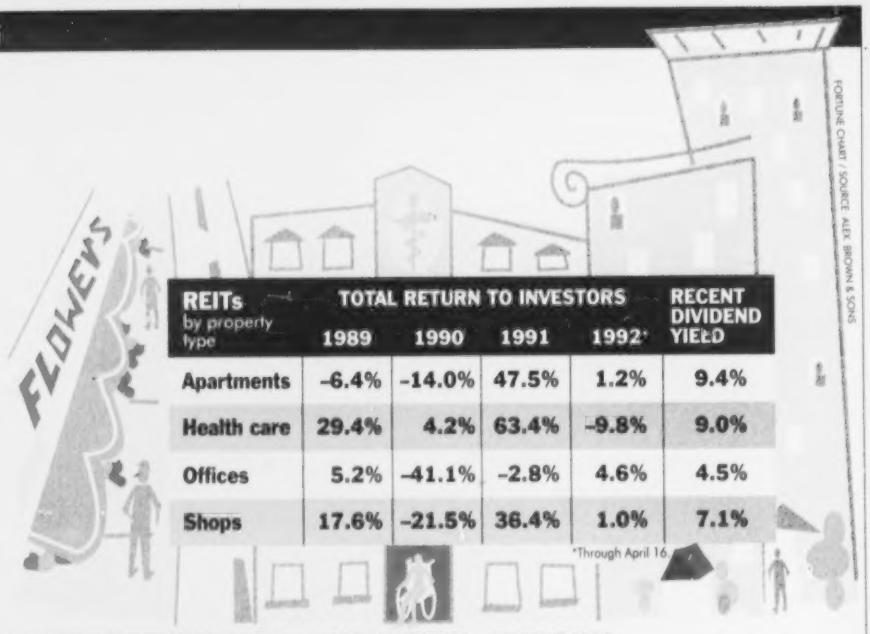
The market hasn't played favorites with the political parties, though for now George Bush leads the pack.

PRESIDENT	YEARS IN OFFICE	AVG. ANNUAL RETURN*
Kennedy (1960-63)	3	9.3%
Johnson (1963-68)	5	7.7%
Nixon/Ford (1968-76)	8	-0.5%
Carter (1976-80)	4	7.6%
Reagan (1980-88)	8	9.0%
Bush (1988-present)	3	12.4%

*For S&P 500, from November to November.

among insurers has reduced the yield give-up for these triple-A bonds to only about 0.15 percentage point. A Hegel recommendation: the noncallable **Modesto, California, Irrigation District** bonds, paying 6.5% and due 2011, currently trading at par.

Another triple-A, triple tax-exempt alternative favored by David Baldt, head of fixed-income investments at Morgan Grenfell, is short- to intermediate-term munis backed by federal housing authorities. Because federal agencies like Ginnie Mae guarantee principal and interest, says Baldt, "these bonds are Treasury notes in sheep's clothing." Consider the Ginnie Mae–backed **Allegheny County, Pennsylvania, Residential Finance Authority** 6.5% bonds.



REITs by property type	TOTAL RETURN TO INVESTORS 1989	1990	1991	1992*	RECENT DIVIDEND YIELD
Apartments	-6.4%	-14.0%	47.5%	1.2%	9.4%
Health care	29.4%	4.2%	63.4%	-9.8%	9.0%
Offices	5.2%	-41.1%	-2.8%	4.6%	4.5%
Shops	17.6%	-21.5%	36.4%	1.0%	7.1%

*Through April 16

FORTUNE CHART / SOURCE: ALEX. BROWN & SONS

WHERE RETURNS ARE—AND AREN'T—BUILDING

Real estate investment trusts are among the soundest operators on America's ravaged real estate scene. Apartment REITs look strong because demand is brisk while supply scarcely grows.

■ **REAL ESTATE.** Like the nerdy kid from high school who roars back to the class reunion in a Ferrari, long-neglected real estate investment trusts (REITs) are getting the last laugh. It's not hard to see why. While private developers loaded up on speculative properties in the Eighties, conservative REITs, disciplined by the demands of the public market, used leverage judiciously and bought properties that actually made economic sense. When the giants crumbled, taking banks, insurance companies, and other financiers down with them, boring old REITs were the only ones left to sift through the rubble.

And what a wonderful wasteland it is. Says Martin Cohen of the investment advisory firm Cohen & Steers in New York City: "It's a buyer's market of unprecedented proportion." Bruce Garrison of Kidder Peabody believes apartment buildings have the best fundamentals. New construction has virtually stopped, and owners are demolishing some older buildings, while the uptick in the economy will increase demand, Garrison says. He especially likes **Property Trust of America**, which buys buildings in the Southwest and whose apartments boast 98% occupancy. The shares yield 7%. Garrison expects shareholders who hold the stock for three years to earn 13% annually in dividends and appreciation.

Health care REITs, which returned a remarkable 63% to shareholders last year, will continue to perform admirably, says Mike Kirby of Green Street Advisors, though the numbers will come down to earth. He likes **Nationwide Health Properties** and **Health Care Property Investors**. Expect a total return of close to 15% annually for the next few years, he says.

Michael Oliver, president of PRA Securities Advisors, thinks muscular REITs that buy community shopping centers will also excel. As frugality becomes chic, centers with "category killers"—successful specialty retailers such as Circuit City Stores—will continue to benefit at the expense of department-store-dependent regional malls. In this category, Oliver says that **Weingarten Realty Investors**, **Federal Realty**, and **Kimco Realty** are the powerhouses.

■ **COMMODITIES.** Will the economy's rebound restore gold's lost luster? Don't bet on it. Experts like Martin Murenbeeld say gold's decline to a recent six-year low of $338 an ounce doesn't signal a bottom. Murenbeeld, an economist at the Victoria, British Columbia, consulting firm that bears his name, notes that gold has a history of poor performance early in recoveries. Says he: "We think gold will average $343 this year, although in a worst case it could fall below $300."

Industrial demand for several metals is in a slump. James Kneafsey, president of the institutional investment firm Cambridge Financial Management, believes many metal prices, already low, could fall another 10% to 15% this year.

That forecast includes silver and platinum. Silver, which peaked in January at $4.41 an ounce, is bobbing around $4 in the face of oversupply. Platinum, a key component of catalytic converters, sold recently at $344 an ounce. Soft car sales and better converter technology that requires less platinum have kept prices weak.

The best way for a commodities investor to play the economic recovery is to buy stocks of efficient metals and mining companies. The key is to choose companies that are technologically proficient, with low production costs and plenty of reserves.

Analyst John Tumazos of Donaldson Lufkin & Jenrette thinks **American Barrick Resources** and **Newmont Mining** fit the bill. By preselling its gold production, American Barrick has locked in a sweet price of $425 per ounce for the next three years. At $23 a share the stock is trading at 19 times Tumazos's 1992 earnings forecast. Newmont Mining is a large, low-cost producer that can make money when some others can't. Its stock, recently $37 a share, trades at 25 times estimated 1992 earnings.

At County NatWest, analyst Ron Shorr favors multifaceted **Freeport-McMoRan** and **Inco**, a leading nickel producer. Shorr thinks both companies can increase earnings per share to $1.75 in 1993. Freeport recently sold for $41 a share. Inco is more volatile, but Shorr considers the stock cheap at $29. F

This report was written by Andrew Serwer (stocks), Susan Kuhn (bonds and commodities), and Shelley Neumeier (real estate).

VICTIMS OF THE REAL ESTATE CRASH

The glut in offices and other commercial properties will keep piling big-dollar pain on financial institutions, taxpayers, savers—and just about the whole world.

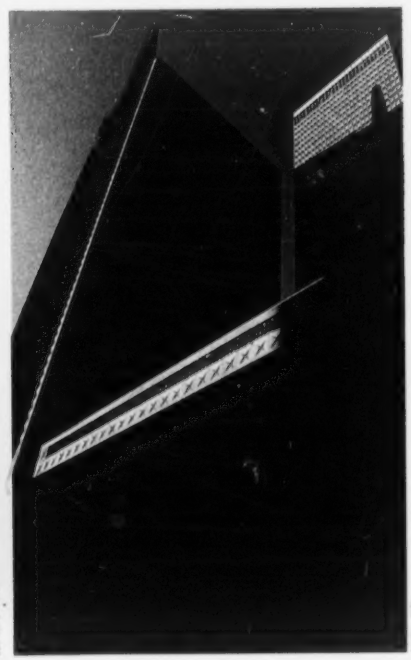
■ *by Carol J. Loomis*

NOT MANY PEOPLE realize just how stunningly big the commercial real estate debacle really is or how savagely it will continue to sweep through the U.S. economy. For a frame of reference, imagine that the stock market—now worth around $3.8 trillion—was to fall in value by 30%, a loss of about $1.1 trillion. Assume also that many of the market's most visible and active participants were on, say, 80% margin. And finally, consider that the economics of the market after the fall suggested strongly that values would stay depressed for years. Would these facts grab your attention?

Substitute "commercial real estate" for "stock market," deflate the dollar figures by just a bit, and you've got the gist of today's drama. There is nothing hypothetical about it. By one estimate the total value of all U.S. commercial real estate was around $3.5 trillion in 1989. It is now perhaps 30% less. Just a diminution of a trifling $1 trillion or so, about twice what the U.S. stock market gave up on October 19, 1987, in the crash heard around the world.

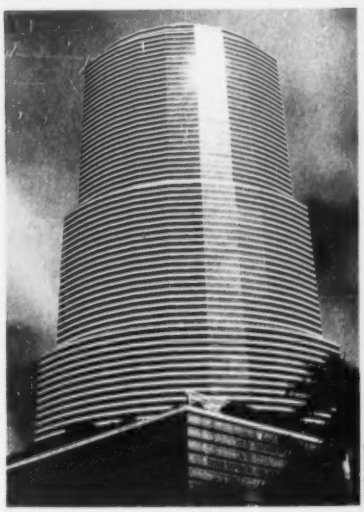
A SKYLINE OF TROUBLED BUILDINGS

You can't hide a distressed office tower, and these are U.S. standouts. Vacant a year and a half, 1540 Broadway in Manhattan (left) just sold for less than half what lenders put up to build it. Dallas's NCNB Center (below), now 75% vacant, once housed RepublicBank, which failed because of troubled real estate and energy loans. The current owner: an unhappy FDIC.



Chicago has more than 25 million square feet of vacant office space, but new structures, among them the one-million-square-foot Chicago Title & Trust building, are still going up. Developer Michael Pepper says his baby is about 35% leased but tenant hunting at prevailing rents hurts: "When an owner signs a lease today, he makes a losing deal for ten to 15 years."

Now called International Place, this I.M. Pei–designed concoction in Miami was originally the home of failed CenTrust Savings. Its innards contain one of the celebrated symbols of savings and loan excess: gold-plated fixtures in the executive bathroom. Built for an estimated $170 million, the tower was taken over in early 1990 by the Resolution Trust Corp., which finally unloaded it last year to Winthrop Financial of Boston for $44 million. Vacancy rate: 50%.



The force of this disaster is smashing into the life of almost every American. Before this mess is over, a large number of buildings that the U.S. simply doesn't need will fall to the wrecking ball. New construction has slowed to a crawl, causing pain to those near at hand, especially in the building trades, and impeding the economic recovery. A coming pinch in property taxes will affect municipal services unless the shortfall can be made up from other sources.

The banks and life insurers that financed all those structures have been gripped by anxiety and driven in many cases to parsimony in the granting of all kinds of loans, not just those to real estate borrowers. The lenders are also still being presented with new catastrophes, most recently the foundering of the Reichmann family's real estate development company, Olympia & York (see box). Ordinary people are uneasy about the nation's financial system. Do you feel a shaft of doubt about the safety of your savings? It was sent your way by commercial real estate.

Because vacancy rates are sky-high—almost 19% for offices—your qualms are apt to continue for quite a while. According to calculations made by Edward Frydl, associate director of research at the Federal Reserve Bank of New York, there is enough excess office space in the nation right now to, in effect, supply the needs of business for the next ten years. To derive that estimate, he assumed an optimistic 3% growth rate for service sector employment over the decade and took past trends as an indicator of how much space each service worker uses. Coming at the problem in a somewhat different way, David Shulman, director of real estate research at Salomon Brothers, has produced an equivalent projection of 11.8 years. So it will be a decade at least before the commercial real estate market comes out from under.

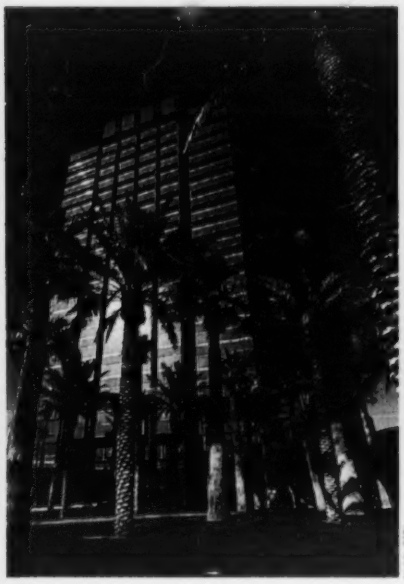
The real estate glut was created by a building frenzy in the 1980s that lost touch

CITY	OFFICE VACANCY RATE as of 3/92
Miami	27.2%
Dallas	26.6%
Phoenix	25.7%
St. Louis	22.6%
Cleveland	22.5%
Manhattan (downtown)	20.6%
Manhattan (midtown)	14.9%
Denver	20.5%
Minneapolis/St. Paul	20.0%
Los Angeles	19.4%
San Diego	19.3%
Atlanta	17.8%
Houston	17.7%
Boston	16.8%
Chicago	16.5%
Detroit	15.1%
Philadelphia	14.6%
Seattle	14.0%
Washington, D.C.	11.5%
San Francisco	10.8%
Honolulu	3.7%

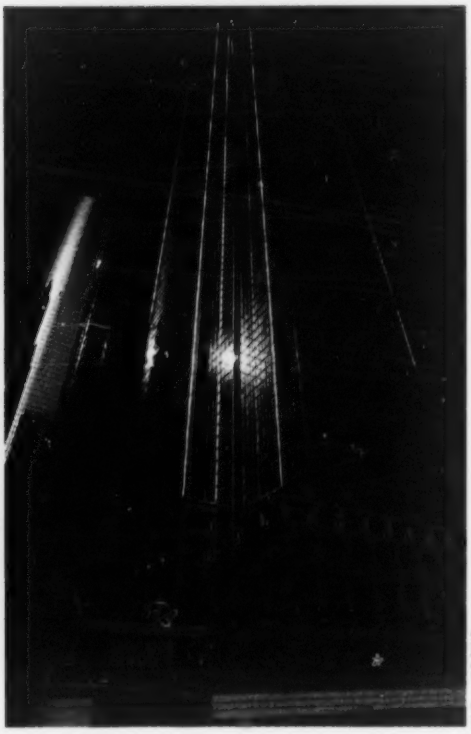
Back in 1981 the national vacancy rate for offices in downtown business centers was 4.8%. Today it's a scary 18.8%. Among the cities where vacancies rose markedly in the last year are Dallas, Cleveland, San Diego, Minneapolis/St. Paul, Los Angeles, Chicago, and Seattle.

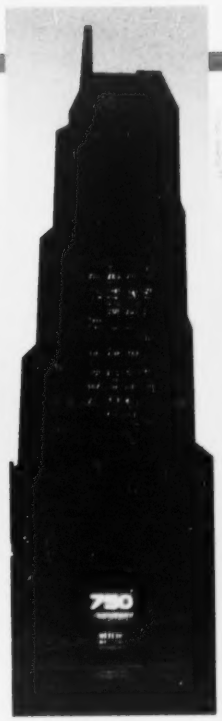
FORTUNE CHART / SOURCE: CB COMMERCIAL

Those palms out front don't signify palmy days for Phoenix Plaza Two, an end-of-the-boom speculation by US West and Newport Beach, California, developer Koll Co. Completed in 1990, the 20-story structure has 400,000 square feet and is 50% vacant. It competes with other strugglers in overbuilt Phoenix, but the leasing agent looks on the bright side: Plaza Two can accommodate a tenant who wants ample space.



Just opened, Two California Plaza has location, location, location in downtown Los Angeles. It is also 77% empty, empty, empty. The landlords, Metropolitan Structures (partly owned by Met Life) and Cadillac Fairview, are trying to hold off leasing until rents head up.





THE RIPPLE EFFECT OF ONE BUILDING

When Developer David Solomon (upper right) put Manhattan's 750 Seventh Avenue into bankruptcy, he left many a creditor hanging. Among them (clockwise from lower right): William Greenblatt of Paramount Plumbing in the Bronx; George Lois, of ad agency Lois U.S.A.; and (left to right) Arthur Carrione, Dominick Moliterno, and Sheldon Feinstein of Bergen County Cut Stone in New Jersey.

with what the U.S. needed in the way of commercial buildings—offices, stores, hotels, apartments, industrial facilities. In turn, the frenzy got much of its steam from wrongheaded tax laws that encouraged this vast misallocation of resources. Even now, the spacemaking machinery isn't entirely turned off. A few end-of-the-boom buildings are still straggling into markets that don't need them, and some contractors are putting up "build to suit" structures designed for the specific requirements of corporate clients.

WORKERS not fortunate enough to land those special jobs have been wracked by an industry unemployment rate of more than 17%. The value of new commercial construction in 1992, as estimated by data gatherer F.W. Dodge and adjusted for inflation, is expected to be the lowest since 1976. The excess space around has rents on a toboggan. At the annual meeting last fall of the sober-sided Urban Land Institute, an important realty research organization, the gloom could not have been cut with a bulldozer. One program moderator, a woman, wound up her session with a distraught cry: "Goddamn it, our industry is in shit!"

Some of what she bewails is important only to the direct participants. Falling rents, for example, are in themselves a zero-sum game: What landlords lose, tenants gain. But falling rents also create a plunge in values that has sweeping effects. Measuring one of these, David Wyss, research director of DRI McGraw-Hill, calculates that for every $1 lost in construction wages, salaries, and profits, suppliers lose $1.07 in business.

To see how the ripples of real estate rock boats all around the economy, consider a new 35-story office tower just north of Times Square in Manhattan. Completed in late 1990, the building, 750 Seventh Avenue, was put up by a once smashingly successful New York developer called Solomon Equities and financed with a $187.5 million construction loan from a Citicorp syndicate. From the front, the building is crisply handsome, a structure of sloped glass surfaces topped by a tapered spire. Toward the rear there are problems: In March a fierce wind blew out several windows, which are now boarded shut. And inside appear the sure signs of real estate sickness. The building is absolutely empty except for a lone security guard in the lobby and a clutch of building employees scattered here and there. Prospective tenants could probably negotiate 18 months of free rent on a 20-year lease. But nobody has signed up—and this business of the windows won't help.

Last year Citi, which is loaded with $6.6 billion in problem commercial real estate assets, moved to foreclose on 750 Seventh "to get the key," as the trade says. But Solo-

mon Equities quickly sidestepped by putting the building into bankruptcy, hoping to salvage a sliver of equity. Among 750's long list of unpaid creditors when it filed for Chapter 11 were Tishman Construction and Otis Elevator. Also hooked were a deli a half-block away that provided food to Solomon's staff and was stiffed for $75; a plumbing company in the Bronx that installed $1.5 million of piping and fixtures; a Manhattan horticulturist whose plants at $2,000 a pot keep the security guard company; a stone company in New Jersey that supplied $1.2 million of granite for the building's lobby and entryway; and Manhattan advertising agency Lois/U.S.A. Some creditors have since settled for less than 100 cents on the dollar, but among those still owed is the ad agency. Says its boss, George Lois, of the $42,267 he's out: "Hey, that's life."

Beleaguered New York City also has a stake in 750 Seventh. Just to get the building up and gracing the Times Square area that the city is trying to lift from sleaze, the Big Apple granted the owners tax concessions for seven years. For now, the building's annual taxes are only $1.8 million and these are being paid by the Citicorp syndicate. But that echoing empty space is a forceful reminder of the sword that commercial real estate holds over this city and many other urban areas.

THOUGH THE RANGE is wide, big cities get an average of 54% of their tax revenues from levies on property and much of that typically comes from commercial buildings. In Los Angeles County the estimated take from commercial property is $2.3 billion annually, and in New York City it's $6.8 billion. Neither locality can afford to lose any slice of that income, yet the drop in values raises the strong probability that they will.

An early real estate casualty, Dallas, has already felt that sting. When property values stopped rising in the middle of the 1980s, the city's first response was to cut services and whittle the pay of municipal employees. Then market values of both homes and commercial properties began dropping. Commercial, though, fell further and faster, from $34.7 billion in assessed value in 1986 to $30.6 billion for 1991. Dallas has raised tax rates for everybody to keep the revenues coming. Still, commercial properties today account for only 66.7% of the tax base, vs. 67.8% back in 1986.

REPORTER ASSOCIATES *Sandra L. Kirsch, Tricia Welsh*

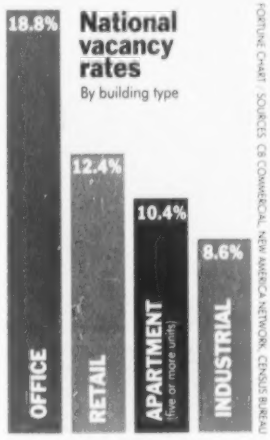
Versions of that script may be played out around the country in the years ahead. Tax revenues from commercial properties are almost inevitably headed down in such overbuilt cities as Chicago, Los Angeles, Miami, New York, and Phoenix—and somebody is going to have to pick up the slack. Maybe you.

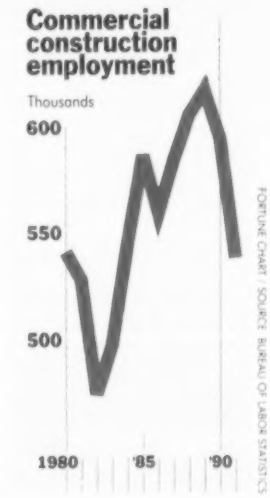
Normally, the whole apparatus of commercial construction helps energize an economic recovery. Not this time. Wyss of DRI/McGraw-Hill believes that the absence of construction's "early kick" accounts for the recovery's difficulty in getting off the ground. Another economist, Kenneth Rosen, at the University of California at Berkeley, thinks the lack of vitality in construction could shave half a percentage point of growth off the recovery ahead.

The repercussions are brutal for anyone who feels compelled to sell property in today's market. Alas, that's all of us taxpayers by way of our agent in Washington, the Resolution Trust Corp. The RTC has been dumping the commercial properties of failed savings and loans at prices typically well below 50% of their original stated value. Every dollar the RTC doesn't get is a dollar added to the taxpayers' bill.

Just how bad things are hits home when private sellers have to step down to accept cellar prices on major properties. The last deal of that ilk to merit national attention involved Manhattan's 1540 Broadway, another Times Square denizen and Citicorp special. Now in Chapter 11, this 44-story, 1.1-million-square-foot glass complex cost an estimated $330 million to build, and was largely financed by a $253 million construction loan provided by Citi and a syndicate of 17 Japanese banks and financial institutions. Completed in late 1990, the building stayed cavernously vacant and unwanted until this March, when the German media company, Bertelsmann, agreed to buy it for $119 million—which will be all the bank syndicate gets, period. Considering the lenders involved, the results give new meaning to the term Japan-bashing.

In many ways, the most profound effects of the real estate crisis are falling, somewhat justly, on the industry's lenders, without whose blessings and bankrolls none of this mess could have materialized. For cons banks and insurance companies have made real estate loans, but this time the injured include lenders that had to detour to find the trouble. Property and casualty insurers don't normally do much real estate finance. Nonetheless, USF&G got the bug for this business in the mid-1980s because of the returns it seemed to promise, and swung right in there with $1.1 billion in mortgage loans and direct investments that are now causing it enormous discomfort.





Several finance companies have taken wicked beatings, among them Household International, which has $667 million in commercial real estate loans and properties and is flailing in the quicksand. In the past two years Westinghouse Financial Services has suffered operating losses of $2.5 billion, mostly from commercial real estate. Its parent, Westinghouse Electric, reported a $1.1 billion loss in 1991 and has watched its stock fall by about 50%.

The commercial banks and life insurance companies simply put themselves on cruise control. All told, banks have about $400 billion in commercial real estate loans outstanding and $26 billion in foreclosed properties for a total exposure of $426 billion. The life insurers have about $256 billion in mortgage loans and $47 billion of real estate they own directly—an estimated $7 billion of that foreclosed properties—for a total of $303 billion. Add up the exposure of the banks and life insurers, and you've got a $729 billion

bundle. That's big. In fact, it's more than twice what the two industries have in equity capital.

How much of that exposure is currently bad news? Government statistics show that at year-end 1991 the banks had $45 billion in commercial real estate loans, about 11% of their total, that were "nonperforming" in one sense or another. Some of these loans were overdue by 30 days or more; some were paying interest but not on the originally contracted terms; and some were actually performing loans on which full payment was nonetheless doubtful. On these loans, bankers were applying some payments received to principal reduction rather than recording them as interest.

For the life insurers, there are no exactly comparable figures. But at year-end, loans 60 days overdue or in the process of foreclosure amounted to about $14 billion. When the properties already foreclosed are added in, the two industries had a $92 billion bag of trouble at year-end. That's $92 billion not contributing fully to earnings and $92 billion of principal under a dark cloud.

With real estate values as unstable as they are now, extraordinary controversy exists about what the carrying value of loans should be on banks' and insurers' books. Are regulators or accountants going to force the lenders to make large provisions for losses to reflect the drastically low valuations that the market is putting on properties? This is not an academic accounting argument. Big write-downs would mean reduced capital, which might drive weaker institutions into mergers and cause some to fail. It is a question of who survives.

The argument recalls the early days of the so-called LDC crisis, when it became apparent that Latin American and other less developed countries could not possibly pay the huge debts they owed banks or anybody else. In those days the regulators tacitly agreed to let the banks carry their LDC loans at unrealistically high levels, so as not to reduce their stated capital to a pittance. But today at least some bank regulators are arguing that real estate loans should not be given the same break. Meanwhile, the state regulators who oversee the insurance companies have until recently been out to lunch on this issue. Though new rules are now being written, mutual insurance companies have not been required by the "statutory" accounting principles they follow to set up reserves for problem loans at all. Some mutuals, among them Prudential and Northwestern Mutual, have nonetheless done so.

PUBLICLY OWNED insurance companies and banks are required by generally accepted accounting principles (GAAP) to carry their loans and foreclosed property at "fair value." By definition, that's the amount at which a transaction—not including forced or liquidation sales—could currently take place between a willing seller and a willing buyer. In a market featuring many transactions, an appraiser would find the fair-value concept entirely serviceable. But in today's market both "willing seller" and "willing buyer" are oxymorons. In general, there is a huge spread between what the seller wants to get and what the buyer wants to pay. Consequently, gridlock prevails, except for transactions that resemble liquidation sales—such as, for example, the Bertelsmann deal.

So appraisers and regulators are forced to fall back on another method of valua-

HOW THE BIG LENDERS RANK IN REAL ESTATE

These tables list the ten largest banking companies and life insurers by total assets but rank them in order of their commercial real estate exposure. One inconsistency in the figures: Nonperformers for the banks include some loans less than 90 days overdue, but those for the insurers do not.

BANKING COMPANY	COMMERCIAL REAL ESTATE ASSETS		
	Total as of 12/31/91 in millions	Total as a percent of stockholders' equity	Nonperforming (loans and foreclosed properties) in millions
Citicorp	$23,000	242%	$6,608
Wells Fargo	$14,233	435%	$1,513
Security Pacific	$12,774	368%	$2,732
NationsBank	$10,994	169%	$1,813
Chemical	$10,706	147%	$2,492
Chase Manhattan	$9,956	187%	$3,336
BankAmerica	$9,544	118%	$1,448
First Chicago	$4,131	139%	$744
Bankers Trust	$3,040	89%	$909
J.P. Morgan	$1,259	21%	$53

LIFE INSURANCE COMPANY	COMMERCIAL REAL ESTATE ASSETS		
	Total* as of 12/31/91 in millions	Total as a percent of policyholders' surplus	Nonperforming (loans and foreclosed properties) in millions
Prudential of America	$29,200	447%	$858
Metropolitan Life	$27,867	585%	$1,725
Teachers Insurance & Annuity	$21,945	718%	$1,581
Aetna Life	$19,071	1,028%	$2,150
Travelers	$13,404	654%	$3,260
Equitable Life Assurance	$12,173	1,100%	$765
John Hancock Mutual Life	$11,135	705%	$534
Connecticut General Life	$10,081	673%	$593
Northwestern Mutual Life	$6,998	423%	$131
New York Life	$6,900	263%	$417

*Does not include real estate held in joint ventures or in separate accounts managed for customers.

FORTUNE TABLES

tion, which is to estimate a property's future cash flows and discount these back to present value. This process has a surface feasibility. But discounting requires you to use an interest rate high enough to compensate for the risk of this investment vs. alternatives, a matter immediately introducing controversy into the calculation. Beyond that, the rules say cash flows should be estimated on the basis of "reasonable and supportable assumptions." How do you possibly determine those in a market that's totally in flux?

To illuminate the challenge, let's look at the phenomenon charmingly known as "tenant migration," which means a renter moves on for better space, cheaper rent, or some combination thereof. Says Richard Boyle, vice chairman of Chase Manhattan: "Right now there is tremendous mobility in the market." Thus, UPS moves its headquarters from Connecticut to Atlanta, and Cabot Corp. returns from the Boston suburbs to downtown—yes, the flow sometimes even goes in that direction. First State Management, a Boston insurance company, leaves an older building in the financial district for a new tower three blocks away. A fact that helps: Asking rents in downtown Boston have dropped from the $50-per-square-foot range in 1986 to $30 or so.

"The tenants are having a picnic," says Boyle. The owners are not. They have resorted to a form of cannibalization in which landlords hold out every inducement possible—cheap rent, no rent for a year or two, lavish improvements, the defrayal of moving costs—to get or retain tenants. So the vacancies roll from building to building. When Bertelsmann occupies its new Times Square pad, for example, it will vacate 500,000 square feet in other Midtown spots.

HOSTAGES TO A WACKY REAL ESTATE WORLD

Executives on the spot (clockwise, from upper left): Victor Palmieri is struggling to turn around Mutual Benefit Life. Bankers Carl Reichardt of Wells Fargo and John Reed of Citicorp are up to their tie knots in real estate loans. Mitsubishi Estate's Kiyoaki Hara, who took flak for invading Rockefeller Center in the first place, now faces more serious problems. A huge number of his leases expire in 1994.

OWNERS with expiring leases live in dread. Mitsubishi Estate owns 80% of the Rockefeller Group and, by extension, the same proportion of Manhattan's renowned Rockefeller Center. Twelve buildings that form the core of the Center have an amazing 45% of their leases expiring in 1994. In the mid-1980s this impending flood of expirations was considered bullish. The average rent on the leases running out was about $42 per square foot and the Rockefeller Group, then controlled by the Rockefeller family, forecast re-leasing in 1994 at an average of $75 per square foot. In your dreams. Asking rents in the Center's midtown Manhattan neighborhood are no better than $39, and Mitsubishi Estate's Excedrin concern has to be whether it can keep tenants at anything close to that rate.

So what value would an appraiser, asked to rely on "reasonable and supportable assumptions," put on this property? It happens there's an answer because Rockefeller Center Properties, the real estate investment trust that holds a $1.3 billion mortgage on the buildings, obtains an annual appraisal. According to James Felt Realty, a New York appraiser, the fair value of the property at year-end 1991 was $1.6 billion, which is down 6% from a year earlier. Were a bank examiner assessing that dainty reduction, he might be skeptical. In any case, among those real estate folk looking smart today are the Rockefellers, for selling 80% of their family company—and a like piece of this rental problem—to Mitsubishi Estate a few years ago for $1.4 billion.

As all this suggests, the range of assumptions that an appraiser or a bank examiner could make about any given building that does not have its tenants absolutely locked up is almost limitless on the downside. Says Craig Hatkoff, managing partner of Victor Capital Group, a real estate firm that advises both banks and borrowers: "In today's market the problem is that 'reasonable' valuations made by a pessimist can be 40% to 50% below equally 'reasonable' valuations made by an optimist. And that's a range that is jeopardizing the capital of the banking system."

The regulators in Washington know that, and they have been backing and filling about how to handle the problem. One faction wants the banks' loan values to be hammered down to reality, whatever an examiner decides that is, and the other faction wants forbearance. Not that anyone

even whispers that word. Since the savings and loans drowned in forbearance, it has become, says a Congressman, "the dreaded F word."

The hawks in the government on this issue are the General Accounting Office and the Securities and Exchange Commission. They want truth in accounting, even if that reveals the capital of some banks to be unacceptably low. Said Comptroller General Charles Bowsher of the GAO to Congress in January: "We strongly believe that accounting needs to report the facts."

Since the S&Ls drowned in forbearance, it has become "the dreaded F word."

The doves are the Treasury, the Federal Reserve, and the main bank regulator, the Comptroller of the Currency. They seem to think that a little fuzziness about the capital position of the banks is in the public interest. In the name of the credit crunch, they have also been bent on encouraging banks to make an occasional real estate loan now and then, though that is close to a futile effort.

The campaign of the doves culminated at the end of 1991 with two flybys put on for the examiners' benefit. First, in November, came an interagency memo that enjoined examiners who are evaluating loans to ignore "worst-case scenarios that are unlikely to occur" and to envision the market's return to normal conditions. Then came a December conference of senior examiners in Baltimore, at which they were urged in golfing lingo to play it down the middle of the fairway and stay out of the roughs and hazards. Presumably this meant that they should not use discount rates high enough to destroy the value of loans and therefore the banks' capital.

So how did the examiners respond? Christopher Mahoney, a senior bank analyst at Moody's Investors Service, says he cannot see that the examiners have so far paid the doves much attention. He points to the examination late last year of Wells Fargo, which has an overabundance of real estate loans and above-average exposure to California's sagging economy. In the vernacular, this examination was "targeted" strictly at real estate loans, and it was immediately followed by the company's announcement that it would add $700 million to its reserves, which raised these to $1.64 billion at year-end.

Says Mahoney of that shocker: "I thought that with all of this pressure coming out of the Treasury and the White House, we wouldn't see any more cases of the regulators moving in and saying your valuation methods are out of line. But that's what I think we saw here. If there were going to be true forbearance, then you might have got a signal from seeing Wells Fargo sail through. The fact that it didn't tells me as an analyst that other institutions are still at risk of the same thing happening."

That's why the possibility of a speedup in bank mergers, and even bank failures, exists. In the meantime, many lenders have buckled down to serious cost cutting, which they hope will pump up their profits and capital. Last summer the Federal Reserve published some statistics on the profitability in 1990 of what it calls "real estate banks," defined as institutions having at least one-eighth of their assets in commercial real estate. About 25% of the nation's more than 12,000 banks fit the definition that year. The other 75%, no great earners themselves, had domestic profits amounting to 0.53% of their assets. Profits for the real estate crowd, which the Fed says included banks of all sizes, were only 0.28% of assets. For these laggards, the difference meant around $2 billion in lost earnings.

Once burned, twice shy. Credit expansion grew more slowly last year than at any time since World War II. The New York Fed's Edward Frydl concludes that the contraction was partly due to lack of demand. But he also believes that the banks' real estate burdens increased their caution about lending not only to that sector but to other would-be borrowers as well. Berkeley's Kenneth Rosen, who is a consultant to banks, says there is no doubt about this spillover effect. "The capital of many banks has been eroded," he says, "and so they're tight with all kinds of lending, not just real estate. I think that will continue for at least a year."

The banks' real estate loans have increased their caution about lending to all borrowers.

In *their* lending, the life insurance companies are similarly cautious. But their risks of loss arise from different circumstances. Typically, banks make construction loans and thus depend for repayment on a plethora of new buildings filling up. They also sometimes lent more than 100% of construction costs. Conversely, the typical loan for an insurer has been a mortgage on a fully leased building against whose value it may have lent 75%. In their loans, therefore, the insurers have been relatively conservative.

Many of their mortgages, though, are on buildings facing a large number of lease renewals, and so the insurers are slated to be unwilling participants in the rollover derby. In the 1980s, moreover, some insurers greatly shortened the maturity of their mortgages because they were using these to "match" guaranteed investment contracts (GICs)—in effect, large deposits—made by corporations placing 401(k) money belonging to their employees. That is, the insurers were offsetting the superior rates they were paying on GICs with the superior rates obtainable on the mortgages and fixing the maturity of each instrument at five to seven years. Many of these "bullet" mortgages are coming due from 1992 to 1994—and a significant number won't be paid.

MEANWHILE, corporations will be pulling their GIC business from any insurer they think overly exposed to real estate problems. So insurers heavy in both GICs and real estate, such as Aetna Life & Casualty, face a liquidity problem as these portfolios mature. Aetna knows it and has been girding itself by socking available cash into highly liquid securities, such as Treasury bills. It has also been in negotiations to sell its American Re-Insurance Co. subsidiary to Kohlberg Kravis Roberts for about $1.4 billion, which would create a lake of liquidity for Aetna.

Chester Murray, a senior insurance analyst at Moody's, says insurers are way behind the banks in their accounting valuations of real estate loans, in part perhaps because they lack a federal regulator comparable to the Comptroller of the Currency. But regulatory pressure for change is building. In the wake of the big failures at Mutual Benefit Life and Executive Life, Congress is considering federal regulation of the industry. The National Association

NEVER BORROW ANYTHING SMALL

There's an old saw in banking: If you default on a $200,000 loan, you've got a problem; default on $200 million, and the bank has the problem. That is how Olympia & York Developments Ltd., the big Canadian real estate company, viewed reality when it met its 91 lenders on April 13 to begin negotiating a restructuring of about $9.4 billion in bank debt (out of a total debt of over $12 billion). As discussions continued in the following days, O&Y prepared to file for Chapter 11 bankruptcy in the U.S. The banks must have felt a gun at their heads: They didn't want to take the huge loan write-offs bankruptcy would bring.

That they would cave in was the gamble that Paul Reichmann, 61—who, with his brothers Albert, 63, and Ralph, 58, owns O&Y—was taking. At stake was a skyscraper empire of 47.4 million square feet that includes New York City's World Financial Center, Toronto's First Canadian Place and Scotia Plaza, and London's Canary Wharf. Given the depressed state of the commercial real estate market in the U.S., Canada, and Great Britain, however, at most only about 37.4 million square feet of that space was producing rental income for the Reichmanns. When the lenders met with O&Y for the showdown in Toronto, the notoriously secretive developers produced financial data on their properties that was over a year old and incomplete. Even more galling to the bankers was the Reichmanns' ultimatum: Accept our plans for restructuring the debt, leave us in charge, waive virtually all principal and interest payments due in the next 90 days, and keep lending us millions more to pay bills during that time—or else.

Bold stuff for an outfit that had already missed several loan payments. After the meeting, Robert S. Miller, an investment banker with James Wolfensohn & Co., which has been hired to represent O&Y in the negotiations, put the threat directly: "If there were a massive refusal by the banking groups to do as the company suggests, O&Y would have to go through a series of filings [for bankruptcy protection] in several countries."

The two men advising the Reichmanns have plenty of experience in this game of chicken—and it did work last time. Miller, 51, and Gerald Greenwald, 56, are former vice chairmen of Chrysler Corp., where they were senior financial executives. As a result, both are accustomed to dealing with lenders in a crisis. A decade ago Greenwald helped Lee Iacocca negotiate the terms of the U.S. government's bailout of Chrysler, and his first day at work as new president of O&Y coincided with the big meeting with the bankers. Says he: "In one way or another it seems I've lived my life this way. But I've never been in a restructuring as big as this."

He never would have been, either, except for Paul Reichmann's determination to deal with the banks as if he still held all the cards. Initially, Reichmann hired Thomas S. Johnson, 51, former president of Manufacturers Hanover bank, to be president of O&Y and to handle the negotiations. But when Johnson, who is highly regarded in banking, finally got on the inside and understood O&Y's situation, he pushed to sell assets quickly. Reichmann, the family's chief strategist, disagreed, and Johnson was out after 20 days on the job. Now O&Y executives are telling reporters that the two men fell out over money, and that Johnson was demanding his seven-figure salary be guaranteed. Johnson refused a request for an interview.

Until recently there was no reason to question Paul Reichmann's confidence in himself. So impeccable was his word that he could close a deal on a handshake, and the world's most sophisticated bankers lined up to lend him money despite his refusal to open O&Y's books to them. The family's secrecy engendered rumors that they were worth billions upon billions, a notion vigorously fanned by various O&Y executives. Occasionally the family would spend as if they really had

JIM WATSON, FINANCIAL POST/GAMMA-LIAISON

The four horsemen of O&Y's apocalypse before the lenders' meeting: Paul Reichmann (left), Albert Reichmann, Robert Miller, and Gerald Greenwald

all that loot. The Canadian news magazine *Maclean's* described a wedding reception for 1,000 guests. At each table there was a bouquet of white roses carefully forced so that during the party they would burst into bloom.

The engine of O&Y's growth is Paul Reichmann's canny risk taking. In 1974 the brothers finished building First Canadian Place in downtown Toronto, which, as with so many Reichmann projects, was financed for more than the cost to build. That gave them some of the capital for the deal that put them on the map: the purchase of eight Manhattan office towers for $320 million in 1977 as New York City was struggling with a calamitous fiscal crisis. The Reichmanns refinanced those buildings in the mid-1980s for $1.5 billion, giving them cash for other deals.

Then in 1981, during the worst recession since the Depression, Paul Reichmann started building the World Financial Center in downtown Manhattan. Against all odds, that handsome granite, marble, and glass development was successful too. Or so it appeared. Though the towers are 91% leased, their 1992 cash flow to the Reichmanns is only $26.3 million, which is projected to rise gradually to $50.5 million by 2002—not much of a return on equity of $525 million. Undaunted, O&Y began work on the first phase of Canary Wharf, the $6.6 billion development in the London docklands, without even bothering to line up construction financing. That's when the worldwide real estate recession, combined with a sharp decline in the value of the family's holdings of natural resource companies, began doing the Reichmanns in.

Now the bankers who rushed to lend are mighty unhappy with the way Paul Reichmann is treating them in the restructuring. Says Alain Tuchmaier, a bank analyst at McLean McCarthy, a Toronto brokerage firm: "The view taken by at least some of the banks was that the O&Y position was unacceptable in its current form." Two years ago Paul Reichmann was asked what would happen if Canary Wharf became a financial disaster. "It would be very unpleasant," he said. As it turns out, his biggest gambles have been unpleasant indeed—for the banks. **– Adam Corelli**

of Insurance Commissioners has imposed a new requirement that all insurers, including the mutuals, be audited and is belatedly writing rules that will make reserves for real estate loans obligatory. And the SEC is investigating the accounting of certain publicly owned, but for the most part unidentified, insurers.

The commission isn't saying much publicly about that project, but it is believed to be on the warpath against the accounting magic that produces a year of good earnings, then a year of big reserve hits, then once again a period of good earnings. The SEC's point of view is that companies should be setting up reserves for real estate loans when these are perceived to be needed and not in huge gobs at carefully selected times that suit the company's convenience.

TRAVELERS INSURANCE has said it is a target of the SEC's inquiry. As they did at Equitable Life two years ago, real estate and GIC problems have sent Travelers in search of a capital infusion or a merger partner. The company's main error in real estate was a binge on Southwest loans and properties some years back. It began confessing its sins with a $415 million provision for reserves in 1988, then came back with another $650 million in 1990. In 1991, by then under the SEC's thumb, it booked reserves of $102 million. The company's profits for the year were $318 million.

The fear that Travelers and any other weakened insurer surely has is that it will meet the fate of Mutual Benefit. That company, once known as the Tiffany of insurers, dropped in class in the late 1980s, when it overdosed on real estate loans and investments. After word spread last summer that the company was in trouble, policyholders flocked to surrender their policies and get their money out. To stop this run, the state of New Jersey seized the company and put a moratorium on further withdrawals. Out went the old management and in came a turnaround artist, Victor Palmieri, known for his work at Penn Central and Baldwin-United. Mutual Benefit is today paying death and disability claims, plus certain annuities. Otherwise, the policyholders who didn't make their escape in time are, at least for now, imprisoned in the company.

Palmieri sometimes sounds as if he were also jailed. He says that dealing with Mutual Benefit's more than $5 billion in real estate assets is extraordinarily difficult, given the state of the market. His doleful summary: "It's impossible to liquidate and it's awfully tough finding a suitor."

Prominent among the countless other insurance and bank executives who face similar troubles is Citibank's Robert McCormack, newly in charge of U.S. real estate and most recently in charge of extracting dollars from LDC debtors. He reports directly to Chairman John Reed, which shows just where real estate ranks in Citi's list of things to agonize over. McCormack hardly exudes optimism about his portfolio. The liquidity problems, he says, are great. But he is cheered by having mostly new structures to worry about. "Over time," he says, "the real problems are going to be with the older buildings." These often require expensive retrofitting if they are to attract tenants, and they cannot easily accommodate today's computer and communications wiring. Without question, they are the prime candidates for demolition in the years ahead.

As for McCormack's liquidity problem, it will not be demolished soon. The universe of would-be buyers is small and inhabited mostly by what Victor Capital's Hatkoff calls "grave dancers, bottom fishers, and vultures." Many owners long for bids from pension funds. But the funds have also been bushwhacked by real estate and are largely sitting on the sidelines.

Arthur Mirante, president of real estate firm Cushman & Wakefield, explains why the market lacks liquidity: "For you to sell me a building, we've got to have some agreement on where the market is going to be three, four, five years from now. Lacking that, most of the deals are going to be forced sales made by owners with financial problems. In that kind of market, the buyers have no reason to move up their bids."

How long, how long, will it take for this burden to be lifted? If regulators push for write-downs, financial institutions will feel the concussions, as in a mine field, by way of bankruptcies, bailouts, and mergers. If regulators exercise the F word, the lenders will be drained slowly and insidiously as they have been by the LDC debt. Ultimately, this problem that arose from a long period of dementia will fade. Chase's Boyle promises that will be so: "In our lifetime," he said recently to a small group of discussants, "the market will turn and go the other way." Too bad if that suggests the timetable in his mind. The oldest person there was 62 and has a life expectancy of 21 more years. F

MORE POWER TO J.D. POWER

Meet the man behind the auto industry's most important customer surveys. He made carmakers focus on quality, and now he is turning to airlines and office equipment. ■ *by Alex Taylor III*

TO THE LIST of such automotive pioneers as Henry Ford, father of the moving assembly line, Charles Kettering, inventor of the self-starter, and Harold Sperlich, developer of the minivan, add J. David Power III, popularizer of customer satisfaction.

You don't think Power belongs in the same league with these guys? Consider this: Since Power published his first Customer Satisfaction Index (CSI) in 1981, keeping customers happy has become a major goal not only for automakers and dealers but also for a good-size chunk of U.S. business. He has helped make "customer satisfaction" part of the language. A search of Nexis, the publications and wire service database, shows nearly 10,000 references to the term since Power's first study appeared.

In autodom, scoring high in the Power rankings has become a preoccupation, celebrated in national advertising and rewarded with higher profits. For four years Honda's Acura dealers festooned the windows of the Integra and Legend with decals reading "J.D. Power & Associates No. 1 Customer Satisfaction Index"—and stood back to watch sales accelerate. Nissan declares that customer satisfaction "is at the heart of everything we do." When it launched its luxury Infiniti division, it made customer satisfaction an explicit aim—above sales, profits, and market share. That Infiniti succeeded in only tying for first place with another new Japanese entry, Toyota's Lexus, dampened its ardor not at all. (This year's CSI winner will be announced in June.)

Says George Borst, vice president of strategic and product planning for Toyota's U.S. sales operation: "Power discovered a niche in the industry many years ago, when it wasn't the top-line issue that it is today, and quantified it. Whether he caused it or caught the wave isn't important." William Pochiluk, who runs the Autofacts consulting firm in West Chester, Pennsylvania, is even more emphatic. Says he: "I think Power has changed the auto business forever. There was a time when he was the only guy in the business making these kinds of pronouncements, and he grabbed the attention of consumers."

Now there are all of 12 Power studies that measure the performance of automakers and their dealers. (The top finishers in five of the most important rankings are shown in the tables.) Last year Power launched the first Canadian CSI. This fall his name should appear on the first Japanese CSI rating luxury cars, produced as part of a joint venture with Japan's Research & Development Inc. Negotiations are under way to set up similar ventures in Europe and Australia. An attempt to establish a European

At 60, Power (center) still travels 80% of the time, though he is delegating more to top associates.

REPORTER ASSOCIATE *Temma Ehrenfeld*

PHOTOGRAPHS BY PHILIP SALTONSTALL

beachhead in Britain failed in the late 1980s, so Power is now aiming to set up operations on the Continent.

Expansion has helped fuel a rapid increase in J.D. Power & Associates' revenues, which are expected to reach $22.5 million this year. That's up 25% from $18 million in 1991 and triple the $7.5 million booked in 1987. One-third of revenues come from industrywide studies like the CSI. Power charges on a sliding scale: Small customers such as Alfa Romeo or Saab may pay as little as $10,000; giant General Motors might put up $100,000. That money buys thick books of data, breaking down the results of the survey model by model across the entire industry. Winners also get the right—for an added fee—to advertise the results.

Another third of Power's revenues come from single-client research, the results of which are secret. Typical recent topics have included salesperson and dealership performance. Power also forecasts auto sales and production by make, model, and plant, as well as manufacturers' plans for new models. All the research supports a growing management consulting business. In addition, Power does extensive training for manufacturers and dealers in, for instance, the fine points of satisfying customers.

Fast growth is changing the character of the 200-person firm, which has its headquarters on a single cramped floor in a nondescript, low-rise office building in suburban Los Angeles. Power, who filled job openings with friends and friends of friends until five years ago, recruited MBAs on campus for the first time this spring. In the past six months, to supplement the home-grown talent, two professional consultants have joined the firm, one from Booz Allen & Hamilton, the other from McKinsey & Co. Power is even creating a new strategic plan to chart the firm's course through 1995.

Scarcely a week goes by without someone showing up with a checkbook to see if the company is for sale. It isn't, but Power says he might consider an offer if it were lavish enough. What the business is worth isn't clear, but Power values the databases his surveys have created at up to $30 million. The books are kept conservatively. Rather than syndicate his industrywide studies by getting the participants to pay for them up front, Power bears all the costs himself. Research expenses are not capitalized but accounted for within two years, though the survey methodology and framework have lasting value and even the old data can be reused to show historical trends. Profits are reinvested in the business. That keeps reported margins low, around 5%, and minimizes taxes.

Says an investment banker who has studied the firm (and prefers not to be identified): "This is a brilliantly conceived company with a very interesting niche. What they do is high quality and should yield 20% pretax. The potential is vast. But they need to manage two transitions: to get their arms even further around the auto business in ways they haven't done before, and to move on to customer satisfaction in a variety of industries, not just one."

THOUGH HE is delegating more management tasks these days, Power, 60, remains his own best salesman and consultant. Known to friends as Dave, he's unpretentious and low key. Some see a striking resemblance to the late actor Peter Sellers. Power travels 80% of the time, visiting Detroit once a month, Japan every two months, and Europe three times a year. A recent stretch of nine days in the office left him with a mild case of cabin fever and a desire to hit the road again.

Power, a Wharton MBA, worked for Ford as a financial analyst and then as a consultant to GM's Buick and GMC divisions before he started his company in 1968 to do market research. Toyota was his first client, but he quickly branched out; today no single company accounts for more than 5% of his business. In conversation, Power sounds more like a reformer or a philosopher than a businessman. Says he: "The big kick I get is making an impact and changing the way that people see things. It's a process, not a goal, and the horizon keeps growing."

Because Power is the most respected and best-known arbiter of consumer-related automotive issues, his studies are occasionally sources of controversy. Some arise from misunderstanding: The CSI and Sales Satisfaction Index are primarily measures of dealer performance; the other three major ones rank vehicle quality. A typical Power study includes 40 makes of cars, but Power publishes only the rankings of the brands that score above average. Those that finish below average he lists alphabetically in the results that are released to the public. Since Power sells his results to literally every manufacturer, he tries to minimize the irritation.

When disputes arise, Power takes pains to mediate them. In the mid-1980s, he opened his studies to three statisticians from graduate business schools for an independent vetting. "That stopped the complaints about our methodology," says senior partner J. Ferron. In the late 1980s, Ford complained

THE TEN TOP MAKES BY FIVE DIFFERENT J.D.

1991 SALES SATISFACTION STUDY

How new-car buyers rate sales, delivery, and vehicle condition
After 90 days of ownership

	Index[1]
Lexus	146
Cadillac	140
Infiniti	138
Lincoln	136
Mercedes-Benz	132
Saturn	131
Buick	131
Oldsmobile	127
Mercury	123
Jaguar	120
INDUSTRY AVERAGE	110

1991 INITIAL QUALITY STUDY

Owner-reported problems per 100 cars
After 90 days

Lexus	55
Infiniti	89
Toyota	90
Mercedes-Benz	99
Acura	109
Honda	111
Subaru	126
Ford	127
Lincoln	131
Mazda	134
Buick	134
Oldsmobile	134
INDUSTRY AVERAGE	140

1991 CUSTOMER SATISFACTION STUDY

How owners rate product quality and dealer service
After 12 to 14 months

	Index
Infiniti	170
Lexus	170
Mercedes-Benz	147
Acura	146
Honda	146
Toyota	144
Audi	140
Cadillac	139
Buick	137
BMW	132
INDUSTRY AVERAGE	127

[1]Industry average was set at 100 the first year each study was conducted. [2]Tie.

After analyst Chris Cedergren (right) quit, Power sued him and George Peterson's AutoPacific for allegedly stealing trade secrets.

about the sample size and the response rates of Power's Initial Quality Study, which, unlike the automaker's own research, ranked Ford beneath its domestic competitors. That proved embarrassing, because Ford advertised itself as America's highest-quality car manufacturer. Ford and Power discussed their separate methods of data collection and interpretation, and both say the dispute has largely been resolved. Ford's quality rating has kept improving, and it now outranks General Motors and Chrysler in the Initial Quality Study.

Placing first in a Power ranking isn't merely good for the ego. As Buick discovered, you can take it to the bank. On May 5, 1989, Power announced that the Buick LeSabre had leapt from 44th to second place in the Initial Quality Study (behind the Nissan Maxima), ranking it the U.S. car with the fewest reported problems. Buick immediately began advertising that fact, and LeSabre sales took off with a whoosh. After increasing 5.7% in April over the previous year and 9.3% in May, they exploded, rising 32% in June, 91% in July, and 99% in August.

Buick's example brought a crush of automakers to Power's door eager to use a Power ranking in their advertising. Power charges clients a $10,000 license fee to do that. In addition, they pay up to $2,500 for approval of each new piece of advertising copy and up to $3,750 for each TV commercial script. Wide use of the Power imprimatur, however, quickly threatened to diminish its value. Chevrolet, for instance, advertised its Lumina as the Power-certified most-trouble-free two-door car in the midsize segment. That was faint praise indeed, since every car answering that description, including the Lumina, had more problems than the average for all automobiles.

The Lumina episode crystallized a growing belief inside and outside the company that a Gresham's law affecting Power rankings was at work. Says Toyota's Borst: "We were the first ones to really use Power rankings in our advertising, beginning in 1987, but after a couple of years it got to be very confusing. Other manufacturers' cars were being advertised that were quite far down the quality list." The year after the Lumina episode, Power put his foot down. As of 1991, the Power name may normally be associated only with the top make in four categories: best American, Asian, and European brands, and best overall. Lexus now occupies first place in three of the studies, which cuts down the opportunities for endorsements anyway.

Power conducts his surveys by mail with lists of registered owners that he buys from a Detroit vendor, R.L. Polk. A typical questionnaire to 70,000 car owners consists of six to eight pages, contains up to 90 questions, and takes 30 to 40 minutes to complete. A dollar bill is often enclosed as an incentive. Power needs about 150 completed questionnaires per model to get statistically valid results. His response rate is phenomenally high for surveys of this kind: It averages 38% and sometimes hits 50%. Power attributes those results to his name recognition and the seriousness Americans bring to buying a car. Least likely to reply are the owners of luxury and sports cars. Presumably the former can't be bothered and the latter are having too much fun.

When the questionnaires come back, a team of 100 to 150 part-time workers processes them. Power uses a two-step procedure to develop the results. The first, called factor analysis, identifies the issues consumers are most concerned about. In the three-year Vehicle Performance Index, for example, they are reliable operation, interior comfort and appearance, interior space, and clear instruments and handy controls. Regression analysis determines how much weight each gets. In the case of the VPI, reliability led with 54%.

JUST AS College Board exams gave birth to cram schools, Power studies have sired consultants who specialize in helping dealers raise CSI scores. Manufacturers and dealers sometimes use devious methods to improve their rankings. One carmaker surveyed 60,000 of its owners a few weeks before the CSI study went out in an apparent attempt to influence the responses; Power says the effect was negligible. Occasional evidence of outright fraud turns up. Individual dealers have tried to stuff the Power ballot box by copying questionnaires and mailing in extra ones. Power catches the cheaters with an electronic scanner and by cross-checking names of responders against a mailing list.

With Power's success, more competitors are trying to slice off chunks of his business. Among the most aggressive is AutoPacific Group, in Santa Ana, California,

POWER MEASURES

1992 VEHICLE PERFORMANCE STUDY

Satisfaction with 81 aspects of performance
After 3 years

	Index
Acura[2]	152
Daihatsu[2,3]	152
Honda	140
Toyota	131
Cadillac	129
Mercedes-Benz	126
BMW	125
Mazda	120
Nissan	116
Buick[2]	114
Lincoln[2]	114
INDUSTRY AVERAGE	110

1992 VEHICLE DEPENDABILITY STUDY

Satisfaction as measured by incidence and severity of problems
After 4 to 5 years

	Index
Mercedes-Benz	176
Honda	157
Acura	150
Lincoln	137
Porsche	127
Toyota	125
Cadillac	121
Nissan	118
BMW	117
Mazda	111
INDUSTRY AVERAGE	101

[3]Company sells only one car model in the U.S.; it is no longer being imported.

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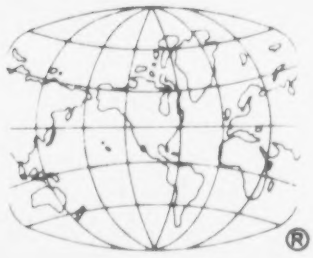

American Intercultural Student Exchange

A non-profit tax exempt organization

founded by former Power analyst George Peterson. Last year Peterson hired Power's well-known forecaster Chris Cedergren and another Power associate to work out estimates of new-vehicle sales and production volume. Power subsequently sued AutoPacific and the two former employees for stealing trade secrets, saying they had taken 14,000 pages and 49 computer disks of confidential information. Peterson says the material wasn't used in creating AutoPacific's own reports and has all been returned to Power. Attempts to settle the suit have failed, and it is headed for trial.

With the market for consumer auto research seemingly approaching saturation, Power is looking for growth in other areas. Besides strengthening his consulting business, he wants to extend industrywide customer satisfaction reports to such products and services as airlines, heavy-duty trucks, recreational vehicles, and office machines. A CSI for personal computers and related products launched last year is being repeated and expanded.

POWER HAS YET to confront the two most important decisions a company founder must make: providing for transitions in the firm's ownership and in its leadership. There are ten partners, two of them newly anointed "senior partners," though Power remains the majority shareholder. Power's son, J. D. "Jamey" Power IV, 29, joined the family firm nearly two years ago after stints at Chevrolet and an advertising agency for Mazda. Poised and articulate, he works a few doors away from his father as marketing manager of automotive research.

Power himself retains enormous zest for his job. Ever the reformer, he has lately applied his survey research talent to developing a customer satisfaction rating for America, called the CSA. After polling 4,650 people, more than enough for a valid national survey, he found, among other things, that Americans are most satisfied with the service they get from supermarkets, emergency rooms, and their telephone companies. In the bottom ten: government, public transportation, car and health insurance, and, yes, car dealers. So far Power hasn't marketed the CSA, but he is already making plans for similar studies in Europe (CSE) and Japan (CSJ). Perhaps someday government officials on three continents may have to answer to constituents about their Power ranking—just as automakers do now. F